VALUING A BUSINESS

The Analysis and Appraisal of Closely Held Companies

Third Edition

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PLAINTIFF'S EXHIBIT
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One of the most significant changes in financial reporting is the erosion of the relative importance of financial statements.[1]

The experienced analyst knows some latitude is permitted in the preparation of financial statements. Rarely do any two companies follow exactly the same set of accounting practices in keeping their books and preparing their financial statements, even within the broad confines of generally accepted accounting principles (GAAP). When it comes to closely held companies, most financial statements are not audited and many provide financial statements that deviate from GAAP, to put it kindly. Therefore, the analyst must evaluate each item and adjust for differences in accounting practices, where appropriate, in order to compare two or more companies or to measure a company against an industry or other standard.

When there is a choice among accounting practices, private companies tend toward a more conservative selection to minimize taxes, while public companies may account more aggressively in order to please shareholders with higher reported income. Also, some public companies try to "manage" their earnings to minimize earnings peaks and valleys by making more conservative accounting decisions in good years and more aggressive accounting decisions in bad ones. Typically, the smaller the private company, the more pronounced the difference between public companies and private companies tends to be.

It is important to remember, then, that shareholders who have control over the company may have the right to change business policies, including the accounting policies followed by the company. This fact should be recognized when the appraisal subject is a controlling ownership interest—versus a minority ownership interest.

All discussion of financial statement analysis in this book is subject to the caveat that generally accepted accounting principles are constantly being reviewed and updated. Also, publicly traded companies are subject to certain disclosure requirements of the Securities and Exchange Commission (SEC), which continue to be challenged and interpreted by the courts.

Complete books are dedicated to the subject of financial statement analysis (see the bibliography at the end of this chapter). The material presented in this chapter is only a refresher to those who are presented with the task of appraising a business or of reviewing an appraisal prepared by others.

The purpose of analyzing income statements is to better understand and interpret the economic earning capacity of the company, since earning capacity is a very important element of the value of a business. Therefore, adjustments to the income statements, in order to better present the earning capacity of the business, generally fall into any or all of three categories:

1. Methods the company has elected to account for its activities, as discussed earlier.
2. Nonrecurring events, discontinued operations, or other aspects of past operations that may not represent future economic earning capacity.
3. Certain discretionary items, such as generous management bonuses.

[1]Kay, Robert S., and D. Gerald Searfoss, eds., *Handbook of Accounting and Auditing*, 2nd ed. (Boston: Warren, Gorham & Lamont, 1989), pp. 1–24.

In many valuations, asset values also play an important role and, therefore, adjustments to the balance sheet may or may not be necessary for analytical purposes. Some variables adjusted for income statement analysis will imply adjustments to the balance sheet because of their interdependence. In other situations, it may be appropriate to make adjustments to balance sheet items that will not affect the company's earning capacity or to make adjustments to the income statement that will not affect the balance sheet.

This chapter discusses the most common categories of adjustments to the income statement and balance sheet in the valuation. It begins with adjustments for different means of measuring asset and liability items. Then it examines a number of items arising from the treatment of revenue and expense items. Finally, it looks at a number of miscellaneous items. More complete discussions of financial statements and the appropriate adjustments of various financial statement accounts can be explored by the reader by referring to other sources, including those in the bibliography at the end of this chapter.

Adequacy of Allowance and Reserve Accounts

It is common to find that a company is either under- or over-reserved for certain items. Some "reserve accounts" should not be considered reserve accounts at all but merely portions of equity that management has chosen to earmark for some future expenditure or contingency. If under-reserved, the effect is an overstatement of earnings due to inadequate reserve charges to expenses, with an accompanying overstatement of net asset value. If over-reserved, the opposite occurs. The analyst may encounter an endless variety of reserve or allowance accounts from time to time and should question and analyze each on its own merits.

Allowance for Doubtful Accounts

Accounts Receivable. Most companies carry accounts receivable and deduct some allowance for potentially uncollectible accounts. The typical policy is to charge some percentage of credit sales to bad debt expense at the time the sales are made. Often a charge (or debit) is made at the end of each month, reflecting that month's credit sales, with a credit to the allowance for doubtful accounts (which is recorded as a deduction from accounts receivable on the balance sheet). Then, as individual accounts are written off, they are credited against accounts receivable and debited against the allowance for doubtful accounts, with no direct effect on either earnings or net asset value at the time of the write-off.

Since the expense charge (or debit) actually represents an estimate of future write-offs, the analyst may wish to make some judgment as to that estimate's accuracy, at least if the effect is material. One way is to compare the historical percentage of bad debt losses with the percentage of current credit sales being charged to bad debt expense to see if too little or too much is being charged. Another procedure is to compare the aged accounts receivable schedule allowance relative to the amount of overdue accounts. Some companies tend to carry receivables on their books indefinitely, with little or no doubtful account

Basic to the analyst's work is the ability to reconstruct the business transactions that are summarized in the financial statements. One can visualize this important skill as the ability to replicate the accountant's work but in reverse order.[1]

Use and Interpretation of Ratio Analysis

When properly employed, analysis of financial statement ratios can be a useful tool in a business valuation. In particular, it can help identify and quantify some of the company's strengths and weaknesses, both on an absolute basis and relative to other companies or industry norms.

The implications gleaned from financial statement analysis may be considered in arriving at the value of the business or business interest in several ways. The most common method of incorporating the results of ratio analysis of financial statements in the final valuation is to make appropriate adjustments to the selection of various fundamental financial multiples (e.g., P/E multiple). To the extent that the ratios indicate sustainable growth, the business should be worth a higher multiple than it would if they did not indicate growth. The higher the degree of risk factors the ratios reveal, the lower should be the business's worth relative to earnings, book value, and other fundamental financial variables.

One use of ratio analysis is to compare a company's figures over time, a method sometimes called *trend analysis*. In this way, one can identify aspects of the business that demonstrate any trends of improvement or deterioration. It can also indicate levels of the different variables that have been normal within the period studied, as well as ranges that reveal high and low points for each variable.

Another way to use ratio analysis is to compare the subject company with other companies, either specific companies or industry averages. Patterns of strength in the subject company relative to guideline companies would tend to support a multiple in the high end of the industry range. Conversely, poor performance ratios relative to similar companies would suggest lower multiples for the subject company.

In comparing ratios from one period to another or from company to company, one should inquire into the extent to which comparative ratios are based on comparable accounting policies. The previous chapter noted that different choices among accounting methods can result in wide variations in reported figures. If one is making a comparative analysis of a company's financial statements over time, one should make an appropriate allowance for any changes in accounting policies. When comparing a company with others in its industry, one should allow for any material differences in accounting policies between the subject company and industry norms.

Another consideration is whether to calculate the ratios before or after any adjustments in the balance sheet or income statement for things such as nonrecurring items, inventory adjustments, or pro forma adjustments. In many cases, these adjustments can significantly affect the magnitude of the company's ratios.

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[1] Leopold A. Bernstein, *Financial Statement Analysis: Theory, Application, and Interpretation*, 5th ed. (Burr Ridge, IL: Richard D. Irwin, 1993), p. 71.

Two factors should guide the analyst in making this decision. First, if the ratios are to be compared to those of similar publicly traded companies, the analyst should make the same adjustments to the statements of both the subject company and the guideline companies. Second, if the computed ratios are to be compared to industry norms, the analyst should make only those adjustments that are likely to put the subject company on a basis comparable to other companies in the industry. In most cases, however, ratios calculated on adjusted statements will reveal a more accurate picture of the company's financial health.

The relative significance of the various ratios will differ in each valuation. Certain ratios have greater significance for value in particular industries. A ratio may be especially significant in some situations because it departs markedly from industry norms. The analyst must judge each individual case when selecting and evaluating the significance of figures as they apply to the particular situation.

If the analyst performs the ratio computations before making the field trip to interview company personnel, the ratio analysis usually will generate some questions about any departures from industry norms. Of course, if the ratio work follows the field trip, the analyst can cover such questions in later telephone interviews.

This chapter discusses ratios that help evaluate the company's financial position. First, it looks at those that measure short-term liquidity, followed by the commonly used longer-term balance-sheet leverage ratios. Then, the chapter discusses a variety of operating ratios. Each ratio is illustrated with an example from our hypothetical company, ABC Grocery Company. A summary of ABC Grocery Company ratios appears in Exhibit 18–3 in Chapter 18, "A Sample Report." All exhibits referred to in this chapter may be found in Chapter 18.

Common-Size Statements

Usually, the first step in ratio analysis of financial statements is to prepare what are sometimes called *common-size statements*. On these statements, each line item is expressed as a percentage of the total. On the balance sheet, each line item is shown as a percentage of total assets. On the income statement, each item is expressed as a percentage of sales.

Exhibit 18–1 presents five years of balance sheets and Exhibit 18–2 presents five years of income statements for ABC Grocery Company presented on a common-size basis.

Short-Term Liquidity Measures

Generally, *liquidity ratios* demonstrate the company's ability to meet its current obligations. Liquidity ratios can help resolve one of the common controversies in business valuations: whether the company has any assets in excess of those required for its operating needs or, conversely, whether its assets fall short of its needs.

Current Ratio

The most commonly used short-term liquidity ratio is the *current ratio*, which is defined as current assets divided by current liabilities. Its greatest significance is as an indicator of the company's ability to pay its short-term liabilities on time.